



Testimony of
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On the
Federal Reserve Board Proposal on Check Truncation
Before the
Senate Committee on Banking, Housing, and Urban Affairs
Also Supported by
Consumer Federation of America
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Good morning, Chairman Shelby, Senator Sarbanes, and Members of the Committee. Thank you for providing me the opportunity to come before you today. I am Janell Mayo Duncan, Legislative and Regulatory Counsel for Consumers Union¹. Consumers Union is the nonprofit publisher of *Consumer Reports* magazine. Our mission at Consumers Union is to test products, inform the public, and protect consumers. Today I offer this testimony on the proposed Check Truncation Act as part of our consumer protection function. My testimony today is supported by the Consumer Federation of America, U.S. Public Interest Research Group, and The National Consumer Law Center.²

If the proposed Check Truncation Act (CTA) is enacted into law, it would have a significant impact on an estimated 45 million consumers who receive their original paper checks in the mail every month.³ The proposed CTA would enable banks, thrifts, and credit unions (collectively referred to in this testimony as banks) to convert original paper checks written by consumers into electronic form so they can be sent by banks to other banks that agree to accept them. Consequently, original paper checks would be “truncated,” or stopped by one of the first banks in the system to process a consumer's check. Banks refusing or unable to accept electronic check information would receive a paper "substitute check." During the check return process

¹ Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education and counsel about goods, services, health, and personal finance. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with approximately 4.5 million paid circulation, regularly carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions that affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

² Consumer Federation of America is a non-profit association of almost 300 pro-consumer organizations, founded in 1967 to advance the consumer interest.

U.S. Public Interest Research Group (U.S. PIRG) serves as the national lobbying office for state PIRGs, which are non-profit, non-partisan public interest advocacy groups with 400,000 members in states around the country.

The National Consumer Law Center is a nonprofit organization specializing in consumer issues on behalf of low-income people. The Center's experienced attorneys work with thousands of legal services, government and private attorneys, as well as community groups and organizations, from all states who represent low-income and elderly individuals on consumer issues.

³ At an August 2002 meeting, bank representatives stated that approximately 60% of consumers east of the Mississippi River, and 30% of consumers in the West receive their original checks back. Since approximately 90%

under the proposed CTA, a consumer's check could be transferred in and out of electronic and paper substitute form. Thus, the consumer's bank would receive either an electronic image or a "substitute check," but would not receive back the consumer's original paper check. Likewise, the consumer could only get back a "substitute check" but not the original.⁴

We believe that the proposed CTA would be a bad deal for consumers for three main reasons. First, the proposed legislation would eliminate the choice preferred by millions of consumers who receive their original paper checks each month. Second, the provisions in the proposed CTA meant to protect consumers from processing errors will not be available to all consumers whose check information is processed electronically. Third, if enacted into law, the proposed CTA would give banks an unfair ability to deter, delay, or reduce consumers' claims for damages resulting from processing errors by alleging that a consumer was somehow at fault.

Potential Impact of Federal Reserve Board Proposal

We recognize the value that advances in technology can provide to consumers in terms of enhanced banking and customer services. However, our concern is not with the technology -- but the resulting removal of consumer choice. The proposed CTA would take a system that works relatively well and change it in a way that imposes new risks and inconveniences on consumers. Today some consumers prefer on-line banking, some receive no checks with their monthly statement, and some receive checks back every month, like clockwork. The proposed CTA would tell millions of consumers that they can no longer get their original paper checks

of the 105 million U.S. households have a bank account, usually a checking account, this means that approximately 45.8 million U.S. households get back their paper checks.

⁴ Today many bank and credit union customers do not receive their checks back in the mail monthly; however, a credit union creates an image of the customer's check at the end of the process, after the check has made its way through the check-clearing process. In contrast, a "substitute check" is a reconstituted version of the consumer's check. Because not all financial institutions will transmit the check in electronic form, the substitute check may contain errors arising during the transmission process. In addition, if the consumer needs the original check due to a claim of improper amount, forgery or alteration (which may require handwriting evidence) the original check will now be in the custody of someone other than the consumer's own bank, and so it would take longer to find and retrieve.

back with their statements to double-check what a bank has done with their funds, to make sure a payee has not changed the amount, or to prove payment where this is an issue. In addition to eliminating this consumer option, the proposed legislation creates a system of electronic transmission of checks that could expose consumers to new risks including double processing of a single check, or errors in reading the amount of or account number on a check -- resulting in losses to consumers.

It is virtually certain that the largest banks will save money from the efficiencies achieved from increased electronic processing of checks. In contrast, there is no guarantee that consumers will benefit from mandatory check truncation. In return for changing their banking practices and being subjected to potential errors related to electronic processing, the consumer is offered vague and unenforceable promises that they will be sufficiently protected, promises of increased flexibility to view account information, and promises that in the future funds from checks they deposit into their account may be available sooner. None of these promises are certainties under the proposed CTA.

Loophole in Legislation Relating to "Recredit" of Disputed Funds

If the proposed CTA were enacted into law, consumers would need additional protections to address any errors or disputes that occur when their check information is processed electronically. In an effort to provide protections, Section 6 of the proposed legislation, among other duties, would require a bank to put up to \$2500 in disputed funds back into a consumer's account if the matter is not settled in 1 business day -- called "recredit."⁵ However, the proposed language would allow consumers to seek recredit of disputed funds only if they receive a "substitute check" from their bank.

⁵ We believe that this amount should not be limited to \$2500. Recredit amounts are not limited for consumers who conduct electronic transfers.

This is a significant loophole because a bank could avoid giving account-holders these rights simply by refusing return substitute checks to them. If a bank does not give a substitute check to its account-holder, the customer loses the right to recredit, and is left with weaker UCC remedies found under state law. Consumers unable to seek recredit would have to seek redress under state law -- UCC Articles 3 and 4 -- which governs negotiable instruments, including checks. UCC liability provisions are not comparable to recredit because, although they provide rules for liability, they lack a non-litigation remedy. In addition, UCC provisions do not set a specific time period to resolve disputes, and do not require a bank to redeposit disputed funds. If a bank delays or declines to solve the problem, the only way for the consumer to get his or her money back under the UCC is to sue, which is too expensive and time consuming for most disputes relating to modest amounts.

Although consumers would benefit from additional warranty and indemnity provisions under the proposed CTA, in order to obtain damages for losses due to an improperly paid check under either the UCC or the proposed CTA's warranty and indemnity provisions, a consumer would be forced to sue his or her bank. As discussed earlier, this is an expensive and cost-prohibitive prospect for most amounts likely to be in dispute. We therefore believe that the recredit provision should be extended to all consumers, regardless of whether or not he or she receives a "substitute check."

Although Inadequate in Current Form -- The Recredit Provision is Critical to Ensure Consumer Protections

Currently, consumers engaging in other electronic funds transfers (e.g. using debit or ATM cards or allowing funds to be debited directly from their accounts) are protected by

Regulation E,⁶ which includes a 10 day right of recredit, and has no dollar limit. Because the proposed CTA would allow banks to turn consumer paper check processing into electronic transmissions of check information, the recredit section essentially gives consumers protections that are similar to those governing other types of electronic funds transfers.

In the absence of any recredit provision in the CTA, banks would lack an incentive to expedite their investigations of possible errors. During the delay, consumers could be denied access to rightful and necessary funds. The recredit provision properly places the burden of delay on the bank rather than the consumer. As described above, in the absence of recredit, for unresolved disputes, consumers would be required to sue their banks in order to pursue claims for improperly debited funds.

The importance of a recredit provision cannot be overemphasized, and has been recognized by its authors. In a letter dated December 17, 2001, Federal Reserve Board Chairman Alan Greenspan presented the proposed CTA to then Senate Banking Committee Chairman Sarbanes, along with an overview of the proposed legislation, and a section-by-section analysis. The “Highlights” section of the overview of the proposed legislation states that: “The expedited recredit procedure is intended to mitigate the effects on consumers of any potential problems associated with the receipt of substitute checks.” In addition, the section-by-section analysis of proposed CTA Section 6 states: “These expedited recredit provisions of the proposed Act are limited to consumers, who are generally not in a position to negotiate with their banks the terms of their deposit accounts that affect the consumers' rights and liabilities, such as how payments are processed and charged to their accounts.”

As recognized by the Federal Reserve Board, recredit is an essential consumer protection element of the proposed CTA. The alternative -- requiring consumers to seek redress by suing their bank over a disputed check processing error -- is an unacceptably unfair, time consuming,

⁶ 12 C.F.R. Part 205.

and potentially expensive alternative. We would therefore oppose any CTA legislation that allows banks to treat checks like an electronic funds transfer, without giving consumers the right to recredit -- a legal protection they need and deserve.

Comparative Negligence Provisions

The proposed CTA contains provisions that would make it harder for consumers to seek damages from banks for improperly paid checks.⁷ These comparative negligence standards in Sections 5(b) and 8(c) of the proposed legislation would allow banks to reduce the amount of damages a consumer can recover by asserting that the consumer was somehow at fault (*i.e.*, comparatively negligent). Despite the creation of this defense, it is highly unlikely that a consumer could contribute in any way to the double processing of his or her checks, or to a processing error. This provision would unfairly enable a bank to deter a consumer's claim, or make any litigation longer and more expensive by asserting that the consumer was somehow partly responsible for check processing errors.

The proposed CTA's comparative negligence provisions are much broader than those currently governing consumer check transactions under the UCC. Although the UCC imposes a comparative negligence standard, it does so only relating to fraud.⁸ The proposed CTA therefore gives banks greater protections than exist under current law by extending a bank's ability to claim a defense of comparative negligence beyond situations where there has been a loss to the consumer due to fraud or forgery. This expansion would make it harder for consumers to collect

⁷ Under Section 8(b) of the CTA, a bank could raise a comparative negligence defense with respect to every claim by a consumer that his or her account had been improperly debited (*i.e.*, a "warranty claim"). See CTA Section 8(b). Similarly, the CTA also would allow banks to raise a comparative negligence defense if a consumer seeks indemnity for harm caused by the unavailability of the original check. See CTA Section 5(c).

⁸ The first instance relates to fictitious payees or imposters [3-404(d)], the second involves where a consumer's negligence contributes to a loss due to a forged signature or alteration [3-406(c)]. Finally, under the UCC, an account-holder has a duty to be diligent in reviewing his or her monthly statement, and report any item paid that was improperly altered or contains an unauthorized signature. If the consumer fails to examine his or her statement and discover and report such indications of fraud, then he or she may lose the ability to assert a claim against the bank for wrongful payment [4-406].

judgments against banks responsible for processing errors. We therefore believe that the comparative negligence standards in Sections 5(b) and 8(c) of the proposed CTA are inappropriate to resolve harms suffered by consumers due to processing errors, and should be removed.

Recommendations

We recommend the following changes to the proposed CTA to more properly balance the benefit of increased check processing efficiencies with necessary consumer protections:

1. Because all consumers are equally susceptible to harm from processing errors, the recredit loophole in the proposed CTA should be closed. The right of recredit should be expanded to apply in every case where the original check is not returned to the consumer and a check may have been improperly charged to the consumer's account; and
2. A comparative negligence standard is inappropriate to resolve harms suffered by consumers due to processing errors. Banks should not be able to use this standard to avoid liability, or to delay a consumer's action for improperly paid checks that result from processing errors. Therefore, as it relates to consumers, the language relating to a comparative negligence standard should be removed from the proposed CTA.

We also have other concerns about the proposal, but we believe that these two elements are among the most important.

I thank the Chairman, Senator Sarbanes, and the Committee for the opportunity to testify, and I look forward to any questions you may have.